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An Overview of California's Enterprise Zone Hiring Credit

L E G I S L A T I V E   A N A L Y S T ' S   O F F I C E

Prepared for:

Assembly Committee on Revenue and Taxation

A Review of California's Enterprise Zone Hiring Credit

Introduction

The Assembly Committee on Revenue and Taxation has requested that the Legislative Analyst's Office (LAO) review the California Enterprise Zone Hiring Credit (EZC), which is available to taxpayers under the personal income tax (PIT) and the corporation tax (CT). Specifically, the Committee requested that the LAO prepare a report that provides background information on the EZC and reviews existing information related to the use and effectiveness of the tax program. In subsequent discussions with the Committee's Chair and staff, it was decided that this report would not attempt to provide original research on the effects of the EZC on individual California enterprise zones (EZs); rather, it would be restricted to a summary of what the economic research has generally found about the impacts of programs like the EZC. It was further agreed that the Committee could follow-up with additional requests if more detailed information was desired.

Pursuant to this request, this report addresses the following topics regarding the EZC:

- Provisions of the credit program.
- Detailed information on how the program functions and applies to taxpayers.
- Descriptive information on program utilization.
- Overview of consensus views regarding the program's impacts on economic activity, taxpayers, and its overall effectiveness.

This report also includes appendices which provide additional information regarding (1) designated EZs in California, (2) requirements of qualified employees, and (3) similar tax credits and other incentives provided by the federal government and other states to EZs.

Background on the EZC

What Is the Basic Purpose of the EZC?

Enterprise zone incentives have been introduced in various states—including California—as a means to encourage economic activity in particular depressed areas. However, California's incentive programs typically have been designed with the intent not only to improve geographic *areas*, but also expand the opportunities available to disadvantaged *individuals* in the state. In particular, the EZ hiring credit has tax incentives that benefit companies locating within a particular zone, but only if certain qualified individuals are hired and conduct a certain percentage of their work within the zone. The emphasis of the program is thus to mitigate the higher costs associated with certain areas and encourage the hiring of less skilled individuals.

What Is the EZC?

Tax Program Basics. The EZC is a tax program that allows certain taxpayers filing under the CT and (in most cases) the PIT to reduce their tax liabilities to the extent that they pay wages to certain individuals for activities that occur within a designated EZ in the state. The EZC was established—along with several other EZ tax incentives—in 1984 and 1985 under the state's Enterprise Zone Act and Employment and Economic Incentive Act, respectively. The Employment and Economic Incentive Act was later repealed and essentially replaced by the Enterprise Zone Act of 1996. The EZC sections in the California Revenue and Taxation Code are 17053.74 for the PIT and 23622.7 for the CT. Enterprise zones and the various credits that are available for activities within these zones were established in California to stimulate development in selected economically depressed areas.

EZC Requirements. The EZC is governed by a number of different requirements regarding employer and employee program qualifications. The credit is only available to qualified taxpayers for qualified wages paid to qualified employees.

- *Qualified taxpayers* are those individuals or firms that are actively engaged in a trade or business within a designated EZ in the state. Taxpayers can include individuals and general corporations, as well as various pass-through entities, such as Subchapter S corporations. Designated zones are listed in Appendix A.

- *Qualified wages* are those wages paid to employees that, in general, do not exceed the greater of the actual wage paid or 150 percent of the federal minimum wage (or California minimum wage, if higher). (For certain aircraft manufacturing activities, qualified wages may include those wages that do not exceed 202 percent of the minimum wage.) For the first year of employment for an individual, the EZC is equal to 50 percent of qualified wages, declining to 40 percent in the second year, 30 percent in the third year, 20 percent in the fourth year, and 10 percent in the fifth year. No credit is available after the employee's fifth year.

- *Qualified employees* must annually conduct 90 percent of their work in activities *directly related* to their employer's EZ activities (meaning that they can't be hired by a company but mainly do work for a company subsidiary located outside the zone), with 50 percent of the work being conducted *within* the EZ itself. In addition, the employee must (1) have been hired after the designation of the EZ and (2) meet certain other personal eligibility standards related to economic disadvantage or dislocation (see Appendix B).

EZC Limitations. The EZC is generally reduced by the amount of other credits allowed for the same employee (for example, the construction hiring credit in the Los Angeles Revitalization Zone). The EZC is limited to the amount of tax liability computed for the business' EZ-related activities. Any unused credit may be carried forward indefinitely until fully used, although none may be carried back to offset previous tax liabilities. A portion of the EZC is "recaptured" to the extent that the qualified employee is terminated prior to the first nine months of employment. The EZC may be used to offset the regular tax liability (and effectively the Alternative Minimum Tax), but not the minimum franchise tax, or the built-in gain tax and excess net passive income tax levied on S corporations.

How Does the EZC Work?

In order to determine the amount of EZC that a business may use, income must be apportioned to the EZ, qualified wages must be calculated, and the credit is then applied to the tax liability attributable to business income from EZ activities.

Apportioning Business Income. For businesses with activities that are conducted both within and outside of EZ borders, business income is apportioned in a manner similar to the apportionment for multistate and multinational corporations. Instead of a three-factor formula involving property, payroll, and twice sales, however, the EZC apportionment formula is based only on the property and payroll factors. (Prior to 1998, the apportionment formula was more closely modeled after those used for multistate and multinational corporations but was altered to make it easier for businesses to use the credit.) The average of the EZ's share of California property and payroll is then multiplied by total California income to calculate EZ income. Figure 1 provides an example of such apportionment and the application of the credit for a business with EZ activities.

Figure 1

Apportionment of Income for a Hypothetical California Enterprise Zone (EZ) Firm

A. California Business Activity Net Income	$8,000,000
B. EZ Income Apportionment Factor	
Property Value in California	
EZ	$13,500,000
California overall	80,000,000
Percent in EZ	16.88%
Payroll Amount in California	
EZ	$4,000,000
California overall	12,000,000
Percent in EZ	33.33%
EZ Income Apportionment Factor	
Average of property and payroll shares	25.10%
C. EZ Apportioned Income	
California net income times apportionment factor	$2,008,333

Calculating the EZC. Figure 2 shows how the EZC is calculated, continuing with the hypothetical example in Figure 1. As shown in the top portion of Figure 2, costs associated with California business activities are subtracted from revenues associated with California business activities, resulting in California business activity net income ($8 million). This income is then apportioned to EZ-related and non-EZ-related business activities. The precredit tax liabilities are calculated for each portion of total income, and the EZC ($900,000) is then used to reduce the tax liability associated with EZ income ($177,537). Since the EZC is larger than the EZ activity liability, $722,463 of the credit is available to reduce the business' EZ associated tax liabilities in future years. In this example, then, the total tax liability of $529,663 is based only on the non-EZ income. Note that, the EZC is only available for business activities; tax liabilities associated with any other income earned by the firm (such as investment income) may not be reduced by applying the EZC.

Figure 2

California Corporation Tax Liability for a Hypothetical California Enterprise Zone (EZ) Firm

A. Calculation of California Business Activity Net Income	
Revenues From California Business Activities	$24,000,000
Costs Associated With California Business Activities	
Qualified wages[a]	$3,000,000
Nonqualified wages	9,000,000
Capital expenditures	3,000,000
Other costs	1,000,000
Subtotal	($16,000,000)
California Business Activity Net Income	**$8,000,000**
B. Calculation of Tax Liabilities	
EZ Activity	
Income[b]	$2,008,333
Precredit corporation tax liability[c]	177,537
EZC amount[d]	900,000
Corporation tax liability[e]	—
Non-EZ Activity	
Income	$5,991,667
Corporation tax liability[c]	529,663
Total State Corporation Tax Liability	**$529,663**

a Qualified portion of wages for qualified individuals.

b See Figure 1.

c Calculated at 8.84 percent.

d Assumes one-half of employee wages are in first year of employment (50 percent credit) and one-half in fifth year of employment (10 percent credit).

e After offsetting the $177,537 tax liability, $722,463 in carryover credit remains.

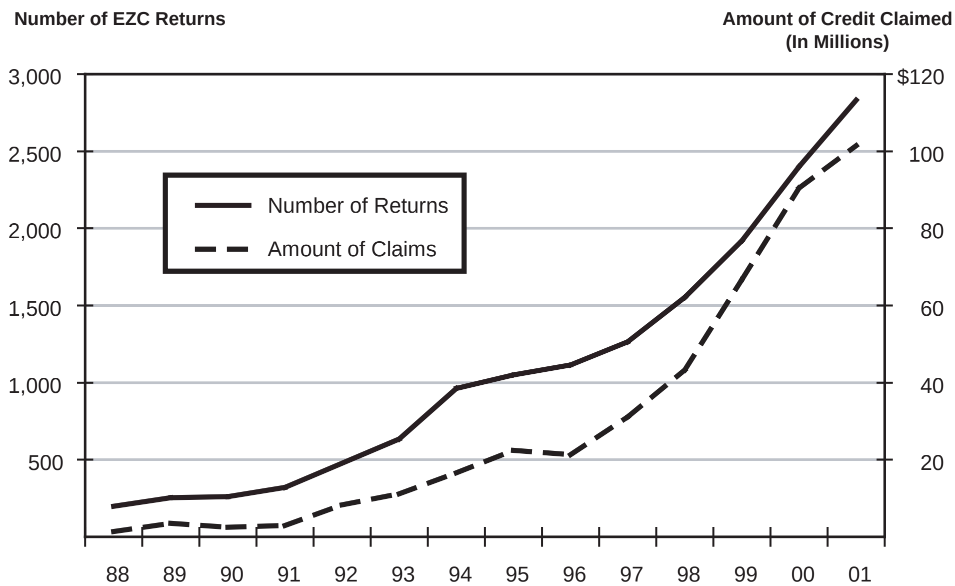
How Has the EZC Been Used?

Direct Revenue Impact of EZCs

In terms of its direct revenue impact on the state, the EZC has a relatively minor effect, although its impact has grown considerably over time. Figure 3 indicates the estimated value and number of EZCs used to offset CT and PIT tax liabilities over the 13 years available. In the 2001 income year, such credits amounted to slightly over $100 million including nearly $70 million under the CT and somewhat over $30 million under the PIT. Much of the increase over the period shown is attributable to the growing number of EZ designations and, to a lesser extent, a somewhat more lenient interpretation of qualified employees. According to the Franchise Tax Board (FTB), which tracks credit usage, the average EZC awarded per claimant under the CT in recent years is about $60,000.

Figure 3

EZC Claims Have Grown Considerably Over the Years



EZC Claims by Sector and Industry

The use of the EZC by CT taxpayers is broadly distributed by industry, as shown in Figure 4 (on following page). The largest dollar amount of credits is concentrated in the heavy industry sector, which accounts for about 25 percent of the total dollar value of all credits. Light and heavy industry together constitute almost one-half of the total amount of credits used. The trade sector represents an additional 23 percent share.

Figure 4

EZC Returns and Claims Are Distributed Broadly Across Industries[a]

2000 Income Year

Industry	Number of EZC Returns	Percent of Total	Value of EZC Claims	Percent of Total
Heavy industry	267	27.7%	$17,230,402	25.2%
Trade	246	25.5	15,483,557	22.6
Light industry	190	19.7	14,907,958	21.8
Nonfinancial services	127	13.1	4,589,367	6.7
Financial services	49	5.1	8,848,476	12.9
Construction	39	4.1	560,466	0.8
Transportation and utilities	29	3.0	6,190,406	9.1
Agriculture and mining	13	1.3	497,808	0.7
Other	4	0.4	61,344	0.1

[a] Credit claims by firms filing CT returns, as estimated by FTB.

EZC Claims by Size of Firm

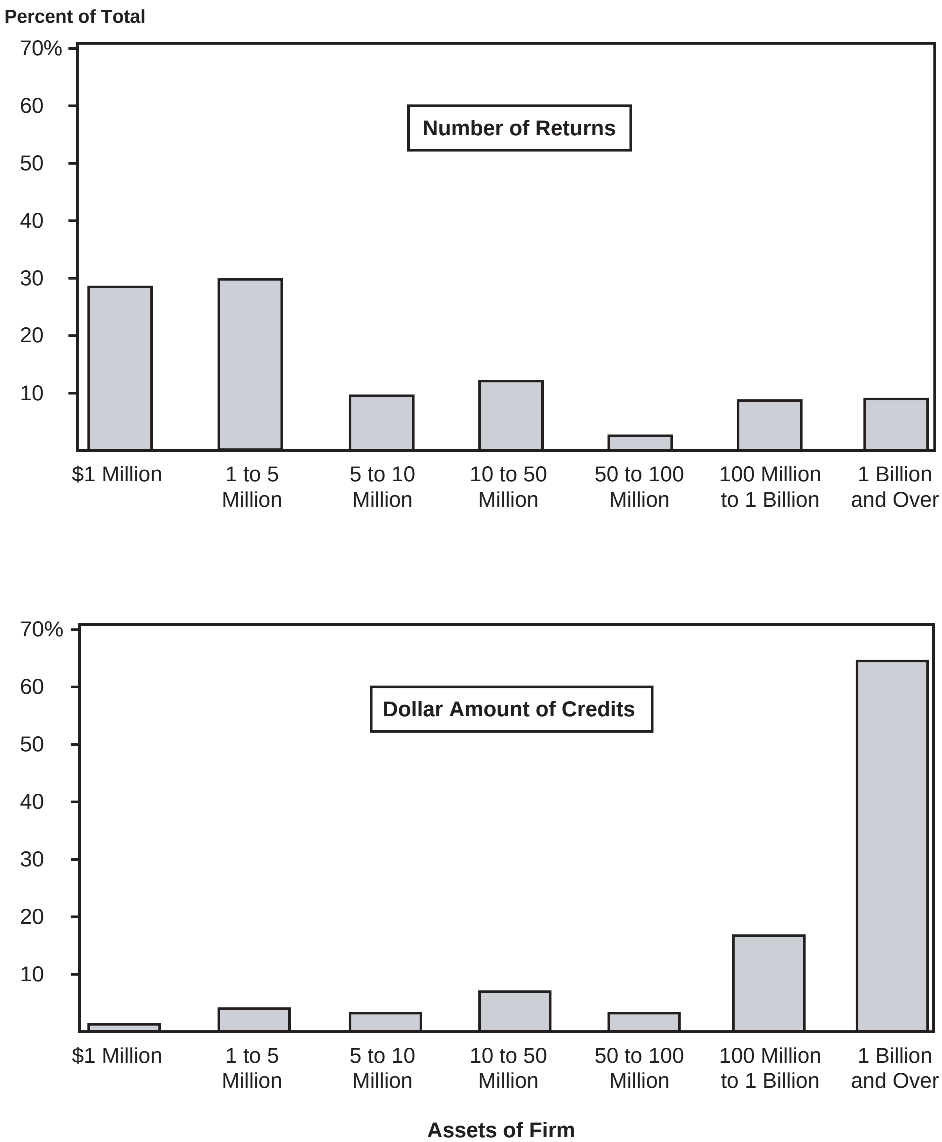
Most tax returns with EZC claims are filed by small- and medium-sized businesses, in terms of assets. As shown in Figure 5 (see next page), roughly 60 percent of returns with EZC claims are filed by businesses with assets of under $5 million. In terms of the actual dollar amount of credits used, however, this is largely attributable to larger businesses with assets in excess of $1 billion. These data suggest that, in the aggregate, most of the benefits of the credit accrue to large business concerns.

Evaluation of the EZC Program

There has been a significant amount of research in the area of the impact of state tax incentives generally. We have provided information on many of these studies and commented on their general applicability to California in our 2002 report: *An Overview of California's Manufacturers' Investment Credit.* In general, the available studies have concluded that state taxes do matter in terms of business location and investment decisions, but the effect of tax incentives is small relative to other factors.

Figure 5

Distribution of EZC Usage Varies by Assets of Firm[a]



[a] EZC claims in 2000 income year under the CT.

While this general rule holds for EZ incentives as well, there are a number of EZ features—such as the size of the zones and the overall investment climate in them—that suggest that there may be somewhat different responses to EZ incentives than to more general tax incentives. There has not been much, if any, research that addresses the issue of the impact on economic activity of hiring credits alone; however, there are a number of studies that have looked at overall tax reductions in designated EZs. Some important general conclusions of these studies are the following:

- ***Intrametropolitan location activity is more sensitive to tax differences than is interstate location activity.*** If a firm has made the choice of locating in a particular geographical region, the existence of tax incentives can have an impact on the choice of location *within* that region, resulting in beneficial effects for the EZ and negative implications for those areas located outside the EZ's borders. This indicates that EZCs may, to a large extent, merely result in *shifting* jobs around within a region, versus *increasing* the total jobs within that region.

- ***Enterprise zone incentives are most effective in assisting a targeted area when the boundaries of the EZ do not extend beyond that area.*** Since EZ incentives do not tend to increase the amount of business activity *in* a region (but rather the distribution of activity *within* it), expanding the EZ will have the effect of reducing the benefits to a particular targeted area within the region. Consequently, from a policymaker's perspective, EZ incentives tend to be most effective in assisting distressed areas when narrowly focused on small geographic areas. This is largely because economic activity will be shifted into the narrow-defined area from elsewhere in the region.

- ***Hiring credits do tend to have a greater impact on job creation than other types of incentives.*** The existence of a labor credit generally—or hiring credits specifically—lowers the price of labor to the employer and can increase demand for labor. Thus, if an increase in qualified labor supply is available to meet this higher demand, EZs have the potential to result in job creation.

- ***Significant tax incentives are necessary to overcome the additional higher actual or perceived costs associated with operating in an EZ.*** Typically, designated EZs have significant shortcomings with respect to infrastructure and labor characteristics. To overcome the additional "costs" associated with less skilled labor or other factors, tax incentives must be relatively large in order to generate additional economic activity. This appears to be particularly the case when a prevalence of unskilled labor exists in an EZ.

These findings from past EZ research are underscored by those of a new study published just last year that concentrated on EZ performance throughout the nation (see *State Enterprise Zone Programs: Have They Worked?*, A. Peters and P. Fisher, 2002). That study, while not without the limitations inherent in this type of research, generally gave a lackluster overall grade to state EZs in terms of accomplishing their objectives, among other things concluding that they typically have little impact overall on new investment and do relatively little to improve the job prospects of the residents of these zones. This is not to imply that such outcomes as hiring-credit benefits in some individual EZs cannot be favorable, depending on the specific circumstances. But the study does suggest that, by and large, EZs and the tax incentives they offer do not have a well-documented record of success in being effective and cost-efficient in meeting their objectives.

Overall Conclusions

The value of the EZC program is quite dependent on the goals that the Legislature wishes to achieve. Available evidence generally indicates that EZ incentives have little if any impact on the creation of new economic activity or employment. Thus, to the extent that the Legislature wished to expand the economic base of the state as a whole, the use of EZ incentives would *not* appear to be a particularly effective means by which to achieve this goal, since many other factors are more important with respect to investment decisions.

On the other hand, EZ incentives *do* appear to be effective in increasing economic activity within smaller geographic areas—such as within metropolitan regions. This is particularly the case with certain types of hiring credits and incentives that are significant enough to compensate for high business costs typically associated with EZs. In general, these local responses are not a result of newly created activity, but rather stem from the shift of activity into the EZ that otherwise would have occurred elsewhere. To the extent that the Legislature places a higher "value" on activity inside the EZ than elsewhere, EZ incentives may be—under certain conditions—an appropriate tool to consider.

An additional aspect of EZ incentives to consider is that they will typically have only an incremental impact on overall EZ characteristics. Enterprise zones frequently suffer from numerous impediments to additional private investment, including aging or inferior infrastructure, lack of adequate public services, and a shortage of qualified labor. Given these fundamental problems—although localized benefits could occur—EZ incentives are unlikely to result in significant *net* positive economic impacts absent additional targeted public investment.

Additional Evaluation Options

Should the Legislature wish to specifically explore the particular circumstances under which EZs can produce favorable results, despite their general limitations, more detailed study on a case-by-case basis of individual EZs and their particular characteristics would be required. This would be a potentially time-intensive and expensive effort, involving both data collection and survey activities. In addition, while the resulting findings could improve the performance of the EZ being studied, they may not be of much help in significantly improving the performance of EZs generally because of numerous other factors affecting economic development in these areas.

Appendix A

Enterprise Zone Designation

An enterprise zone (EZ) designation is effective for 15 years and, under certain conditions, may be renewed. For the 2002 tax year, the state had 39 designated EZs as shown on the following page in Figure A-1.

Figure A-1

Enterprise Zones (EZs) in California[a]

2002 Tax Year

EZ Area[b]	Designation Date	Expiration Date
Altadena/Pasadena	April 10, 1992	April 9, 2007
Antelope Valley	February 1, 1997	January 31, 2012
Bakersfield/Kern County	October 15, 1986	October 14, 2006
Calexico	October 15, 1986	October 14, 2006
Coachella Valley	November 11, 1991	November 10, 2006
Delano	December 17, 1991	December 16, 2006
Eureka	October 15, 1986	October 14, 2006
Fresno	October 15, 1986	October 14, 2006
Kings County	June 22, 1993	June 21, 2008
Lindsey	October 6, 1995	October 5, 2010
Long Beach	January 8, 1992	January 7, 2007
Los Angeles-Central City	October 15, 1986	October 14, 2006
Los Angeles-East Side	January 11, 1988	January 10, 2003
Los Angeles-Harbor	March 4, 1989	March 3, 2004
Los Angeles-Alameda Corridor	October 15, 1986	October 14, 2006
Los Angeles-Northeast Valley	October 15, 1986	October 14, 2006
Madera	March 4,1989	March 3, 2004
Merced/Atwater	December 17, 1991	December 16, 2006
Oakland	September 28, 1993	September 27, 2008
Oroville	November 6, 1991	November 5, 2006
Pittsburg	January 11, 1988	January 10, 2003
Porterville	October 15, 1986	October 14, 2006
Redding/Anderson	November 6, 1991	November 5, 2006
Richmond	March 2, 1992	March 1, 2007
Sacramento-Army Depot	April 5, 1989	April 4, 2004
Sacramento-Florin/Perkins	April 5, 1989	April 4, 2004
Sacramento-Northgate	October 15, 1986	October 14, 2006
San Bernardino County/Riverside County	October 15, 1986	October 14, 2006
San Diego/San Ysidro/Otay Mesa	January 28, 1992	January 27, 2007
San Diego-Barrio Logan	October 15, 1986	October 14, 2006
San Francisco	May 28, 1992	May 27, 2007
San Jose	October 15, 1986	October 14, 2006
Santa Ana	June 8, 1993	June 7, 2008
Shafter	October 4, 1995	October 3, 2010
Siskiyou County	June 22, 1993	June 21, 2008
Stockton	June 22, 1993	June 21, 2008
Watsonville	May 1, 1997	April 30, 2012
West Sacramento	January 11, 1988	January 10, 2003
Yuba County/Sutter County	October 15, 1986	October 14, 2006

a Cities and towns, unless otherwise noted.

b EZ includes portions of each designated jurisdiction.

APPENDIX B

QUALIFIED EMPLOYEES FOR THE EZC

For Tax Years Prior to 1997

Qualified employees were required to fall under one of the following categories:

- Receiving services under the federal Job Training Partnership Act (JTPA) or its successor.
- Eligible to be a voluntary or mandatory registrant under the Greater Avenues for Independence (GAIN) act, or its successor.
- Eligible, as determined by the California Employment Development Department, under the federal Targeted Jobs Tax Credit Program.

For Tax Years After 1997

Qualified employees must meet any of the following characteristics immediately preceding their employment with the taxpayer:

- Eligible for JTPA or GAIN.
- An economically disadvantaged individual, dislocated worker, disabled individual eligible for a state rehabilitation plan, service-connected disabled veteran, Vietnam War era veteran, ex-offender, welfare recipient, Native American, resident of the enterprise zone or other similarly designated area, or member of a "targeted" group as specified in federal Internal Revenue Code Section 51(d).

Appendix C

Federal and Other States' Enterprise Zone Incentives

Federal Programs

Enterprise zone (EZ) incentives have appeared in federal law several times in the past, most recently in 1993, when the federal government established the Empowerment Zone Employment Credit (EZEC). The EZEC entitles employers to claim a credit for the first $15,000 in wages paid to a resident of an empowerment zone designated by the Secretary of Housing and Urban Development and the Secretary of Agriculture. To qualify, employees must perform substantially all of their employment services within the designated zone and in the employer's trade or business. The credit percentage depends upon the particular empowerment zone and the year that the wages are paid or incurred. Effective in tax years beginning in 2001, the amount of the credit is 20 percent of qualified wages paid. The amount of the credit claimed may not be deducted as wages.

Programs in Other States

A number of other states provide EZ tax incentives, as shown in Figure C-1 (see next page). The data in the figure include all types of EZ incentive tax credits available through a state's corporation tax, and are not limited to hiring credits only. The number of zones varies widely. For example, Michigan has only one zone while Louisiana has 800. Thirteen states do not have any type of EZ designation or program.

Figure C-1

State Enterprise Zone Tax Incentives—By Type

State	Income/Franchise Tax
Alabama	C[a], E[b]
Arizona	C
Arkansas	C
California	C, D[c]
Colorado	C
Connecticut	C
District of Columbia	C
Florida	C, R[d]
Georgia	C
Hawaii	C
Illinois	C, D
Indiana	C, E
Iowa	C
Kansas	C
Kentucky	C
Louisiana	C
Maryland	C
Massachusetts	C
Michigan	C
Minnesota	C
Missouri	C
Nebraska	C
New Jersey	C
New Mexico	C
New York	C
North Carolina	C
North Dakota	C, E
Ohio	C, E
Oklahoma	C
Oregon	C
Pennsylvania	C
Rhode Island	C
South Carolina	C
Texas	D, R
Utah	C
Virginia	C
Washington	C
Wisconsin	C

a Credit.
b Exemptions.
c Deductions.
d Rebate.

This report was prepared by Mark A. Ibele and reviewed by Jon David Vasche. The Legislative's Analyst Office (LAO) is a nonpartisan office which provides fiscal and policy information and advice to the Legislature.

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